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UNCLAS SECTION 01 OF 03 SHANGHAI 000534

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SUBJECT: SHANGHAI STOCK EXCHANGE BREAKS THROUGH 5,000

REF: A. SHANGHAI 332
 B. SHANGHAI 325
 C. HONG KONG 2183

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1. (SBU) Summary: The Shanghai Stock Exchange's Composite Index (SCI) rose above the "psychologically significant" 5,000 point level for the first time on August 23, closing at 5,032. The market has risen 80 percent since the beginning of 2007, adding to the 130 percent gain in 2006. The SCI ended July 2007 at a record 4441 points and gained 591 points -- 13 percent -- in the past three and one-half weeks. Consulate contacts almost uniformly remained bullish on the market and were confident that market fundamentals support the 5,000 points level. Recent regulations granting Chinese investors increasing freedom to invest overseas, particularly in Hong Kong, would be more significant in the long-term since expected RMB appreciation and gains in Chinese markets makes keeping money at home more attractive in the near-term. Market analysts did not anticipate any moves by the central government aimed specifically at reducing heating in the stock market, but noted that macro-economic measures designed to address inflation and sectoral overheating might affect the markets. End summary.

Market Fundamentals Support 5,000

2. (SBU) Lombarda China Fund Manager Ian Midgely (Ref A) told Econoff on August 24 that the 5,000 level was a "psychologically significant barrier," but one that is clearly supported by the underlying market fundamentals. The fundamentals are sound. Efforts over the past few years to restructure the companies that are listed on the exchange are now paying off with "quite spectacular profit results." "This is also the first time I have seen Chinese companies put the interests of its shareholders first. They are starting to look more like Western

companies," he said.

13. (SBU) Midgely expected in the short term to see some volatility, and even a temporary correction back to as low as 4,000 points. However, he would "be very surprised" if the market did not close above 5,000 points at the end of this year. Furthermore, he believed that the market would be up an additional 50 percent in 2008. "Look," he said, "I know that this sounds crazy if you think about the market starting out at 1,000 points last year. In China, it takes a long time to get things started, but the companies have taken the hard steps to restructure. This is what is driving investors. It takes things a long time to get started in China, but once the process gets up to speed it just keeps going. China has for years been so far behind where they should have been that these gains just make sense," he said.

14. (SBU) According to Midgely, policy makers are not concerned by rising stock market levels. The stamp tax increase on May 29 (Ref B) reflected their concerns about the churning effect and unpredictability caused by speculators "stir-frying" their accounts. Raising the prices of trades was "exactly the right thing to do" as it dampened the numbers of small trades and encouraged investors to pour their money into mutual funds. With fund managers accounting for more and more of the trading volume, policy makers have increased confidence in the rationality of the market. "It is better to let fund managers drive the market," he said.

15. (SBU) Another reason Midgely did not expect policy makers to issue any "massive or draconian" measures to cool the market was the upcoming IPOs of such important companies as China Mobile, China Petroleum and the China Construction Bank. (Note: In a separate conversation on August 24, Shanghai Stock Exchange (SSE) Deputy Director Chao Kejian said that the China Mobile IPO on the SSE would be delayed due to resistance from Hong Kong Stock Exchange's leaders who were concerned about maintaining Hong Kong's special role. End note.)

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16. (SBU) The August 20 announcement by the State Administration of Foreign Exchange that Chinese citizens would be allowed to invest in overseas markets through a special trading account at the Bank of China Tianjin Branch, meant that over the long term the values of companies listed both in Shanghai and Hong Kong would come together. (Note: There are some companies that are traded both in Hong Kong and Shanghai. Given the limited-convertibility of the RMB and other financial restrictions, there have been wide P/E differences between shares prices of the same company. End note.) In the short- to medium-term, however, Midgely did not expect that arbitrage would actually be as easy as reported since structural impediments remain. He did not expect that P/E ratios on the Hong Kong exchange would rise to 30-40 and did not expect that the P/E of these companies traded in Shanghai would fall to 20. (Ref C)

SSE: 5,000 -- Not a Big Event

17. (SBU) Shanghai Stock Exchange Deputy Director Chao Kejian said, on August 24, that the SSE management was not viewing the crossing of the 5,000 point line as a "big event." "We don't think that this is very meaningful." Chao said that the recently released mid-year corporate balance sheets showed companies listed on the SSE averaged profits over 50 percent.

18. (SBU) Chao said that if profits continued to be strong, SSE price to earnings (P/E) ratios would fall from the 50s range to 33 by the end of the year. The key issue for continued growth was that China's economic environment continues to be conducive to economic growth and expansion. These macro-economic questions were dependent on whether or not the central government would tighten economic controls or fiscal policy.

The overheated real estate market and heavy industry sector had policy makers "worried" he said. They might take steps to cool off those sectors and this could lead to declines on the stock market. Interest rate increases by the People's Bank of China were aimed at inflation and not at the market, he said.

¶9. (SBU) SSE internal forecasts were for the market to rise to 5,500 or 6,000 by the end of the year. Chao was optimistic about market sentiment given the expected IPOs of such quality companies as China Petroleum, the China Construction Bank, the Bank of Beijing and other big companies. Given the political sensitivity of the next couple of months as China holds the 17th Party Congress, Chao did not expect any major policy changes that would affect market stability.

Will Access to Overseas Markets Trigger a Crash in China?

¶10. (SBU) Industrial Securities Research Analyst Shi Hong told Econ Assistant on August 24, that since China's macroeconomic situation remained unchanged with continued excess liquidity and ongoing RMB appreciation, the current stock market "bubble" appeared to be "very sustainable." Shi expected that the market would reach 6,000 points by the end of the year. He expected that the central government would continue to tighten monetary policy by raising interest rates and bank required reserve ratios, but it was "highly unlikely" that it would take any steps directly aimed at the market such as the May 30th stamp duty increase. It was the central government's aim to maintain a "Harmonious Society" among the retail investors. This meant that the government wanted to avoid getting blamed for any negative outcomes from its policy, he said.

¶11. (SBU) In the long-term, Shi said, allowing Chinese investors to purchase stocks freely overseas might trigger a crash in the Chinese markets. "Maybe when we look back ten years from now, the trigger to an A-share market crash will be fully tradable H-shares by regular residents," he said. Shi asserted that the SSE is a "policy market," controlled by the central government and subject to political tinkering. In contrast, Hong Kong's stock market and other markets around the world are free from political control. Once investors are free to invest in

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whatever markets they want to, should the central government take any "harsh" steps to rein in China's markets, investors will flee overseas (or to Hong Kong). Investors have confidence that Hong Kong's exchange is free and driven by market forces rather than politics. Nevertheless, given the current environment of RMB appreciation and massive gains, investors found the SSE a more attractive market at this current time.

The Bulls are Running in Shanghai

¶12. (U) Other consulate contacts expressed the following views on August 24:

¶13. (SBU) CITIC Fund Management Company Senior Vice President for Business Development Peng Yan said that the market will continue to advance due to investor confidence. In the short-term, she expected that both individual and institutional investors will pour new money into the market. New mutual fund launches will also cause market advances since they are forced to purchase stocks despite their high prices. Should the government issue policies aimed at contracting the market, she anticipated that the market would respond with a drop as sharp as the recent gains.

¶14. (SBU) Deutsche Bank Research Associate Hong Tianfeng Hong noted that while 5,000 points sounded like a high number, over 60 percent of stocks were still below their May 30 level, pre-stamp tax increase, level. Hong believed that this left "limited room for a market correction."

¶15. (SBU) Haitong Securities Company Director Wu Bing said that "there was too much money in the market." This excess liquidity, combined with recent company profit statements, was what had pushed the markets up. Like other analysts, he expected that the SSE's high P/E ratios would decline as these profits continued to grow. For example, while the banking sector, the SSE's largest sector (REF Shanghai 478), has a high P/E ratio, the growth rate of banks' profits has been at least 30 percent. Since this growth rate was expected to continue for the next two to three years, its current high P/E ratio was not actually representative of reality and "quite acceptable."

¶16. (SBU) Shenyin & Wanguo Securities Company Li Qinghai said that over-liquidity in the market would continue pushing up the market. High returns from the equity market were attracting more capital into the stock market. She noted that August 23's gains came after yet another PBOC interest rate hike. While there might be some adjustments, Li was extremely bullish on future market performance.

¶17. (SBU) Guotai Junan Research Analyst Kevin Luo said that the market was unlikely to experience a significant dip despite the "stretched valuation" at 5000 points. Luo said that that the market was being sustained by the increasing number of new investors bringing new money. "On the other hand, as a primary research brokerage house, we no longer see any more under-valued stock picks," he said. It was Guotai Junan's house view that the A-share and H-share price difference would narrow from the current 60 percent to 20 percent in the next two years.

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